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THE EFFECT OF THE EUROPEAN WAR ON AMERICAN CREDITS

Prior to the declaration of war between Germany and Austria on the one hand, and England, France, and Russia on the other, there were many people in this country who professed to believe that on account of our large and varied resources we could build a fence around America and could live entirely independent of the rest of the world; but events subsequent to the declaration of hostilities quickly dispelled that idea, and the paralysis of business which followed reflects the financial interdependence of all the leading nations. Much has been said about the necessity of America insisting on her rightful place in the world-business. We want to go into every nook and corner of the world and sell our handiwork. But as we create trade with South America, or with Europe, or with any other part of the world, just so far do we increase the interdependence of ourselves and the other nations, and the more quickly and surely will our country respond to disasters abroad. Utterly fallacious is the idea that this country is so rich in resources and possesses so much of the human genius of the world that we can isolate ourselves from other peoples. We are interdependent; we should be interdependent—in our economic, in our social, in our intellectual relations, and in our sympathies.

Our nation and our nation's business felt the shock of the catastrophe almost as soon as it occurred, and the most ominous

results threatened. The fact that within a period of two or three days the exchange markets of the world were so disturbed that cable exchange on London rose from $4.87½ to $5.25 per pound sterling, and was unobtainable at that; the fact that the stock exchanges had closed two or three days before, thereby barring the avenue through which securities were marketed; and the further fact that the civilized world at large was horrified to think that in this so-called enlightened age it was possible for three or four of the most important nations in the world to jump at each other's throats—all these factors created such a feeling of fear that even in this country our business was more completely paralyzed than ever before. The panic of 1907, severe as it was, was not comparable to the situation through which we have just passed.

There are two sorts of financial mechanism at the service of our bankers in a time of crisis when every effort must be made to keep unimpaired the reserves that support their credits in the face of the various opposing forces that seek to draw down these reserves. These instruments are the clearing-house loan certificates and the emergency notes authorized by the Aldrich-Vreeland act of 1908.

Clearing-house certificates are notes used solely by banks in the settling of the debits at the clearing-house. They are issued against securities deposited by the bank using them (at the rate of 75 per cent of the par value of the securities), and they draw interest at the rate of 7 per cent. Such certificates were first used in Chicago in 1907, and they were so successful in conserving the money supply that a resort to them was immediately determined upon in our present crisis. About $15,000,000 worth of these certificates were issued in Chicago, nearly a million and a half in amount more than on the previous occasion. This time, however, none reached the hands of the general public, as some of the smaller denominations of clearing-house notes did in 1907, because the banks could now use in their transactions with the people the Aldrich-Vreeland notes.

These latter are the notes of national banks, issued, not against government bonds as has been required by the National Bank Act, but against municipal or industrial bonds, or commercial paper (at

the rate of 90 per cent of the par value of municipal bonds and 75 per cent of the par value of the other two classes of paper). All notes now issued by national banks are alike in appearance whether they are notes issued regularly against government bonds or otherwise. Previous to the passage of the Aldrich-Vreeland law all bank notes had read: "This note is secured by a deposit of United States bonds with the Treasurer of the United States." At the time that law was under consideration the point was made that banks would not wish to issue a note that could in any way be regarded as inferior to other notes regularly issued. The result of the discussion was that the Treasury Department was forced to destroy the old plates and to issue new ones for all the seven thousand odd banks, in which the inscription reads: "Secured by United States bonds or other security." To procure these notes a bank must be a member of a currency association—a group of not less than ten national banks with an aggregate capital not under $5,000,000. Each bank guarantees, not only its own notes, but also every other note of this kind issued under the association. As a result this asset currency is in every way exactly as good as our bond-secured currency. There has been a national currency association in Chicago since 1911, and that body was prepared to meet the situation that followed on the opening of the war. On Tuesday, August 4, our banks opened on a clearing-house certificate basis, and on the same day the currency association met. Four or five banks made application through this association for $9,000,000 in circulating notes, depositing at the same time bonds or commercial paper to the requisite amount. These securities were placed in the vaults of the clearing-house association for safekeeping and have there remained. On Friday of that same week our $9,000,000 worth of notes were received from the subtreasury. About $360,000,000 in such notes were issued throughout the whole United States. The Aldrich-Vreeland notes are strictly emergency paper, designed to protect reserves in extraordinary times, and to be retired immediately on that necessity ceasing to exist. They consequently draw interest (under an amendment passed August 4, 1914) at the rate of 3 per cent for the first three months, which appreciates thereafter ½ of 1 per cent each thirty days until it reaches 6 per

cent. When a bank desires to retire its emergency circulation it may deposit with the Treasury at Washington the necessary lawful money. Then when its notes are presented for redemption the amount is credited to that account and they are burned. Undoubtedly all of these notes will be retired long before they reach the point of drawing 5 per cent.

The problems produced by the closing of the stock exchanges and the markets abroad were very serious, but the gravest feature of the whole situation was the wide-spreading, intangible fear that accompanied these critical events. For fear means destruction of confidence, and confidence in men and in conditions is the most potent factor in all that goes to make for business stability. This is true because the vast bulk of our business—95 per cent in fact—is done on credit, and credit and confidence are one and indivisible.

The public generally does not understand the credit nature of banking operations nor the character of bank deposits. Bank deposits are not money; they are credits, and they are obtainable in a good many different ways. They can be secured through the deposit of money or checks or other credit instruments, or through the discount of a loan, the proceeds of which are placed to the credit of the borrower and thereby made available for checking purposes. A multiplicity of operations can be performed exclusively by credit instruments without the intervention of actual cash in any of the transactions. Suppose a man holds a thousand shares of stock worth $125.00 per share. He may believe the stock is going higher and may not wish to sell, although he needs the money to conclude the purchase of a building. He therefore borrows $100,000 at the bank, signing a note and depositing the stock as collateral. The bank, after deducting the discount, places the amount to his credit. The borrower is then in a position to buy the building, consummating the deal by a check upon this account. Perhaps, the man to whom the check is made does not do business with the bank on which the check is drawn. He will, however, deposit the check with his own bank, and that bank is paid by the first bank in the course of the operations at the clearing-house. The entire process has not involved the use of

actual money at any time. Against these deposits is carried the reserve, the lawful money which, under the law and measured by experience, banks keep in their vaults as an assurance that they will be able to meet on demand the needs of the public. Anything that tends to lower these bank reserves unduly is a menace, and the forces active in a time of crisis have just that tendency.

Ignorance in regard to the real character of bank deposits exists among big depositors as well as among small depositors. A great many people in 1907 were prone to criticize the banks of the country because they could not and did not undertake to pay on demand. As a banker, I was myself frequently confronted by this attitude. I recall in particular a certain man with a balance of $20,000 to his credit in our bank at that time. He came one day to complain because he could not get out of the bank what he had put into it. He was assured that he could, that he would receive just what he had deposited. Examination of the records disclosed the fact that practically the entire $20,000 was made up of checks and various other paper drawn on points scattered over the whole of the United States. He had not, as he admitted, sent in a single dollar in cash or currency, and yet he was insisting that the bank pay him cash on demand. With this prevalent misconception of the credit nature of the banking business, it is inevitable that the public is frightened if the banks are obliged to refuse payment on demand. On the other hand, when extraordinary conditions like the closing of the markets prevent banks temporarily from realizing on loans which are in reality safe and sound, and so put pressure on the banks' cash supply, the latter cannot pay on demand without resort to extraordinary devices. It is to meet just such emergencies that clearing-house certificates and the Aldrich-Vreeland notes have been devised.

The closing of the American stock exchanges followed soon after the closing of the European exchanges, for European investors, forced to realize cash wherever possible, were throwing their securities on the American markets in huge lots. Not only did this upset seriously the prices of stocks and bonds, but it created a debt which America, under the foreign exchange

situation, could not pay without—and this is the important point—the exportation of gold. The closing of the exchanges was unavoidable, but it brought very serious problems in its train. First the difficulty was to determine how we were going to handle the stock-exchange securities. Various issues of our stocks and bonds, representing both industrial and railroad enterprises, were listed on the stock exchanges of the different cities of the world. Those securities up to August had been regarded as the most liquid of any securities the banks could obtain as collateral for loans; that is, they were the most readily convertible or exchangeable into some other form of credit which would fill the needs of the individual who might own them. Until the war crisis the banks in general had felt that they could demand payment upon a matured note when it was secured by stock-exchange collateral, confident in the belief that the owner could go and sell the stock at some price and pay his obligation.

Immediately following the closing of the stock exchanges all that class of paper—the amount of which I cannot state, but in New York City it probably aggregated $300,000,000—all that class of note collateral was not worth the paper it was written on so far as its utility to secure cash payment was concerned. The intrinsic value of these securities was, of course, the same as before, but, the markets being closed, there was no place in which to sell them. New York bankers realized that a very large percentage of the country's liquid paper was tied up, out of which they had expected to take care of demands for loans for crop-moving and other business incident to the fall of the year. They could not realize a dollar on this paper. There was no one through whom they could offer the stock for sale, and no one to buy. Confidence was seriously disturbed, and the bankers and government officials agreed that decisive measures must be taken to maintain at all hazards our organization of credit, and to put borrowers in a position where they could renew credits they could not pay on demand. To preserve the gold supply so essential to the validity of the credits extended was one of the strongest reasons for the use of clearing-house certificates and the issuing of Aldrich-Vreeland notes. The banks, then, under the law of self-protection, began

to hoard gold and to put out notes. The result did impair confidence to a certain extent. Deposits were materially reduced; yet this reduction was not due entirely to apprehension on the part of the public, but in part to the liquidation that immediately set in.

The situation with reference to foreign exchange was anything but satisfactory. When we took stock of our debits and credits we found that we owed to England and Germany and France and the other nations of Europe all told about $500,000,000, maturing between August 1 and January 1, $200,000,000 of which was immediately due. Among those obligations was one of special importance as to size, maturity, and distinction so far as the maker was concerned, and that was the $82,000,000 owed to Europe by New York City. New York City has had a habit of borrowing money on its year's warrants, and because it could place those warrants in French and English markets cheaper than at home this loan was made in London and in Paris and its payment was guaranteed in gold and in pounds sterling on the other side.[1] It seemed apparent that unless we conserved our gold under the existing conditions, with these large obligations to be paid abroad, our organization of credit was likely to be greatly impaired. With international trade practically at a standstill, the only method of paying this debt seemed to be in gold, and yet to pay it in that way meant a ruinous demand upon our reserves. It was therefore absolutely essential that we conserve our gold and prevent it from reaching channels whence it would flow abroad; to secure this end we relied upon the use of clearing-house certificates and the emergency notes.

It may be helpful at this point to consider briefly the splendid way in which England managed her own situation, a situation far more difficult to cope with than was ours. The government first declared a moratorium, as did all the principal countries of Europe, thus postponing the obligatory settlement of accounts. Then the government stepped in behind the joint stock banks and guaranteed every acceptance which was held by them and dated prior

[1] I have been told that somehow since the declaration of war and the disturbance of business which has been so paralytic in its effect, this agreement for payment in pounds sterling has been given up and disposed of.

to August 2. Not only did the government guarantee the solvency of the maker and the borrower, but it guaranteed that a renewal acceptance might be made within a year. That act was a master-stroke and it promptly restored confidence. The Banking Department of the Bank of England, with an average gold supply of less than \$150,000,000, extended its loans to \$330,000,000 in a month, and, furthermore, announced that it would guarantee the banks against loss on all acceptances made before August 2. A favorable response was immediate. The discount rate which had gone to 10 per cent receded to a lower rate than prevailed in Chicago or New York. There were an enormous number of acceptances offered for discount at first, and for thirty days the Bank of England discounted very freely. As a result the gold reserve dropped from 52 per cent to a trifle above 14 per cent. At this point the bank announced that so much paper had been offered for discount that it would be compelled to discount less freely until conditions were more nearly normal, and that thereafter it would open this department of the bank for but a portion of each day. Confidence had been restored, and reserves were then gradually increased.

In the meantime, however, England, as well as France, was demanding that the United States pay her debt in gold. That was a physical impossibility to us, owing, for one thing, to the fact that our reserves are divided among twenty-five thousand individual banks. In England they are concentrated in the Bank of England and sixteen clearing-house banks.

We did not want to part with the gold and we did not think that we should, for we knew that the demand in those countries for our foodstuffs and other commodities must eventually offset our debt; though, at that time, the prevailing conditions made it impossible to finance such transactions. An exporter of goods to Europe draws a draft on London which is presented to the importer through a bank, or acceptance house, and by him is accepted. The draft so accepted becomes eligible for discount at the Bank of England; it creates a credit there in favor of the American exporters, and helps in the settlement of the trade balance between the two countries. The practical cessation of exports for the first

weeks of the war destroyed the medium through which we were wont to pay our debts, and the limited discounting of the Bank of England interrupted the free play of these adjusting forces. Consequently all our exports since September 1, shipped under bills drawn for 60 or 90 days or for 4 months, have only just begun to have an influence toward the restoration of a normal condition; since, instead of being able to draw at once on the proceeds of the discounted acceptance, we had to wait for our funds until the bill matured. England's need for gold, however, was imperative, and she was insistent that we pay some of our debt to her in gold directly. The New York City debt was particularly urgent, and yet the New York banks could not have given up that great sum in gold without serious embarrassment. To keep the gold in the United States we availed ourselves of the clearing-house certificates and the Aldrich-Vreeland notes. To do our part toward relieving the English situation we organized the so-called Gold Pool.

The Gold Pool is a fund of $100,000,000 subscribed by national banks in reserve cities to guarantee the payment of our debts in London. Chicago banks subscribed $16,000,000 of this sum. Ten per cent of the total amount was forwarded by the subscribing banks to a committee of the New York Clearing-House Association and a portion of it was deposited by them at Ottawa, Canada, to the credit of the Bank of England; and that institution was notified that in an emergency we were prepared to furnish a larger sum. This act relieved the tension greatly. The Bank of England, assured that gold for her reserves would be forthcoming if needed, commenced to discount more freely, and the foreign exchange situation consequently began to readjust itself. Exchange on London by November 1 dropped to $4.90, and banks in this country can now take the exporter's draft with confidence that it will be discounted in London and that they will not have to wait for payment 90 days or until the draft becomes due.

The advance in interest rates which the banks made this autumn has been the subject of much adverse criticism. The banks have been charged with taking advantage of an exigency and with

extorting money from a people in distress. This judgment has perhaps been natural, but it has not been the outcome of a real understanding of the situation. When the banks went on a clearing-house certificate basis the bankers in Chicago did not intend to advance interest rates, although the clearing-house certificates draw 7 per cent interest and the current rate was but 6 per cent. We felt it better for us to bear this burden than to adopt an abnormal rate on loans. In the meantime, however, we were confronted with the fact that loans falling due could not be paid owing to the closing of the stock exchanges. This affected not only our own loans but the loans of all our correspondent banks made through us. It is the custom of banks in smaller cities to make deposits in the banks of Chicago and other large cities, which pay them 2 per cent. When these deposits exceed the amount deemed necessary for ordinary business exchanges, our correspondents are likely to ask us to loan out certain sums at the larger interest which commercial transactions permit. We do not guarantee the note made; we guarantee only diligent and helpful service. The banks of Chicago had about $20,000,000 thus loaned for correspondents at the outbreak of the war. When stock-exchange paper was found to be valueless, the bankers in Chicago urged their correspondents not to press the makers of these notes for payment, as the money had been borrowed in good faith and the fact that it could not be repaid was due to the exigencies of the war. We knew that an effort on our part to collect such notes not only would have resulted in bankrupting many of those borrowers but would also have resulted, had this collateral been offered at auction under suits at law, in a depreciation of values that would have been disastrous. This would have brought failure after failure throughout the country. Accordingly, our correspondents acquiesced in our suggestion that loans be allowed to run at the rate of 6 per cent, and they did so up to August 18.

About this time, however, the urgency for money caused many big borrowers to bid for money through the commercial note brokers. The opportunities for profit to grain men and exporters of flour and other commodities badly needed abroad were such that these exporters were seeking money at even an extraordinary interest rate. They had given note brokers in Chicago a million dollars

worth of their paper to be offered at 7 and even 7½ per cent. The banks, both our own and our correspondents, were thus placed in the position of carrying paper long overdue at a rate from 1 to 1½ per cent under the rate at which the best current paper was selling. It was natural that our correspondents objected to this discrimination. The matter was thoroughly discussed, and after finding that many people were imposing on the banks, borrowing solely from fear and thus asking for credit which they did not really need, we determined that an advance in the rate was justifiable. That step was taken about August 20. If our correspondents could not collect their money, we felt that they ought to have the current rate; moreover, we thought that the adoption of a higher rate would help us to keep the situation under control. The interest rate is the most forceful lever for the maintenance of reserves in time of stress. Change in the discount rate is the method by which the Bank of England adjusts its reserves, and it has been found perfectly effective to reduce unnecessary loans and to call into that country in time of need money from all parts of the world.

The cotton situation in this country was another one of the serious problems brought forward by the war. The South this year produced an enormous cotton crop—about 15,000,000 bales. In ordinary times probably 60 per cent of this crop would go abroad to the markets of Germany, England, France, Russia, and Austria. With these markets closed there are not buyers for half of it. Consequently the price of cotton, which for the last three or four years has averaged about 12 cents a pound, dropped to 6 and 6½ cents, some little cotton of a superior grade being sold at 7 and 8 cents. The loss on 15,000,000 bales, with approximately 500 pounds to the bale, is stupendous. This is a loss, not only to the South but to the whole country, for our debt abroad would usually be liquidated by the export of this crop. Thus far very little cotton has gone abroad; ultimately much of it will; for our cotton represents a staple demand and the European countries cannot depend on the rest of the world to meet their requirements.

As business returns to normal there will be a demand for a good deal of cotton in this country. Let the southern farmers sell all

they can at the best prices they can. The North has a keen interest in the welfare of the South, and northern creditors will not press their southern debtors. The southern banker and merchant can in turn be lenient with their unfortunate debtors, and tolerance, restraint, and common sense will tide the planters over until another year. But the permanent remedy for the economic condition of the South is a greater diversity of crops that will not permit the catastrophe that reliance on one crop may entail.

The opening of the federal reserve banks on November 16 will undoubtedly serve to ease the situation in this country markedly. The release of about $480,000,000 hitherto held as reserves will supply abundant means to finance new undertakings and to grant credit to replace some of the foreign capital withdrawn. The interest rate in Chicago will no doubt drop immediately. The signs seem to presage prosperous times for the immediate future in this country, with our factories running full time and with the men now idle employed. For some nation must do constructive work to compensate for the destructive work going on abroad. The declaration of peace, however, will bring the severe test to our business. The present unusual foreign demand for our goods will to some extent cease, and foreign capital which has helped to establish our industries will be withdrawn more or less to re-establish European industries. What that may mean can perhaps be imagined from the statement that foreign investors hold from four to six billion dollars worth of our securities. It may very likely be that the progress this country has made in recent years will be somewhat retarded, that a scarcity of money and a higher interest rate will prevail. The problems presented will be acute and perplexing. The settlement of the war will bring a readjustment of the investment funds of the world; but by a foresighted and wise use of the twenty-five billions of dollars of banking power in the United States we should eventually be able to secure our full share of the world's business, which has hitherto been denied us by our antiquated banking system. Again I say, hand in hand with the growth of nations and their participation in each other's affairs goes increased interdependence.

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